

Legal and Institutional Reform

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Module Objectives

- To strengthen your ability to **apply** specific **ideas** from economic thinking **to project** design, implementation, and evaluation.
- To clarify some terminology
- To set realistic expectations for this area of programming

Agenda

- Review basic microeconomic **theory**
- Introduce **ideas** from “New Institutional Economics”
- Identify laws that we typically address in LIR projects
- Note lessons learned from past **experience**
- Do group exercise - real world example of **reform**
- Learn about an assessment toolkit for legal reform, available from USAID/W
- Outline links between Legal and Institutional Reform and **Corruption**

First, a few questions about you.

- I need 8 volunteers to answer out loud.
- Have you ever bought a product on line?
- Do you prepare your own tax return?
- What are the topics of the projects/activities in your current “portfolio” – what projects do you currently manage?
- How do you measure success in your professional career?

Why should ECONOMIC growth officers care about LEGAL and institutional reform?

Economics analyzes how people reconcile what they want with what is possible. In other words, various constraints exist, so that people must make choices. Peoples' choices have consequences for society.

To change economic performance, we often need to change peoples' choices. To change choices, we need to change constraints.

Life is full of constraints!

- Budget constraints
- Technological constraints – the production function

AND ALSO CONSIDER.....

- What will other people let me do, or help me do, or do for me? What is legal? What conforms to social norms?

→ NEW idea: “institutions”

For the moment, a simple definition:

“Institutions” are rules of behavior.

Institutions arise in each and every society –
institutions distinguish an organized society
from complete anarchy.

(We’ll come back to the definition of
“institutions” after the next slide.)

Why should economic growth officers care about legal and institutional reform? *(cont'd)*

INSTITUTIONS MATTER

Why? They shape **incentives**, they shape peoples' choices, they shape economic behavior.

Empirical evidence confirms this claim – see reference list in binders, particularly recent paper by Steve Knack.

What is an “institution”?

- ✓ “Rules of the game”
- ✓ Organizations, like banks, corporations, government agencies, etc.
- ✓ Laws and regulations set and enforced by government
- ✓ Widely accepted behavioral practices, although not officially sanctioned by law

All of the above

EXAMPLE: A “Capital Markets Development Project” addresses different types of institutions and various economic decision-makers:

- securities law and implementing regulations
- the securities commission – a state organization
- self-regulating private sector organizations like the exchanges
- investors and shareholders and corporate managers

ANOTHER EXAMPLE of an institutional reform project:

“Agriculture Ministry Restructuring”

- What is the role and the functions of the Ministry of Agriculture? Does it carry out production? Issue licenses and approvals? Regulate production or prices? Own resources? Supply services?
- How many agricultural producers are at subsistence level? How important are informal institutions?
- To change incentives for Ministry officials and staff, is “civil service reform” needed? How are people hired, compensated, promoted, evaluated, and dismissed?
- Is the Ministry’s “information management system” an “institution”?

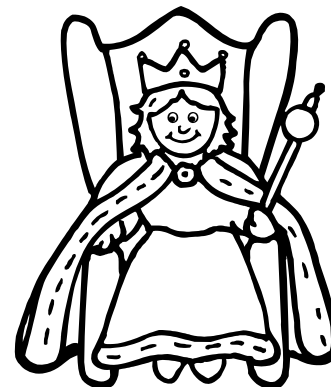
Why do societies have institutions?

To coordinate different peoples' interactions across time, across geography, across large groups of people.

To coordinate different peoples interactions in the presence of uncertainty about the future or about other peoples' intentions.

To make transactions easier, less expensive to conduct.

Examples of common institutions



Are formal institutions good, informal institutions bad?

- No – that’s much too simplistic.
- Formal institutions are “within the law”, whereas informal institutions exist “despite the law”.
- Informal institutions mean that people are dependent on personal relationships to structure interactions, whereas formal institutions allow people to interact without personal connections.

What distinguishes “good” institutions from “bad” institutions?

Bad Institutions:

Inequality
Uncertainty & Risk
Externalities

Good Institutions:

Inequality
Uncertainty & Risk
Externalities

Where do institutions come from?

- History matters. Each society inherits institutions from its past.
- Interest groups matter. People who share interests will work together to change society's rules, society's expectations of behavior. Institutions evolve over time, even without projects to push reform.

What institutions matter to your projects?

- Are these institutions at the “micro” level? Or the “mesa” level? Or the “macro” level? In other words:
- individual’s behavior – your wage goes down by 10% causes you to
- organization’s behavior – the Ministry of Finance should changes M.O. from harassment to customer service, or business associations
- Economy-wide context – contract law, company law, banking law, etc.

Key questions to ask about any particular “institution”:

- ❖ Does it help people carry out their transactions?
- ❖ Does it facilitate accurate information flows?
- ❖ Does it make clear rights and responsibilities (costs and benefits) of various economic agents? Does it enforce rights and responsibilities?
- ❖ Is it accessible across the population?
- ❖ Does it facilitate collective action to address collective problems?
- ❖ Does it address principal-agent problems?
- ❖ Does it create monopoly power?

NIE: Transactions Costs

- Transactions costs include not only the costs that parties bear to conduct transactions (e.g., a lawyer's fee to write up a contract document) but also the costs of dealing with uncertainties and informational gaps that inevitably accompany transactions.

Collective Action

- Collective action is coordinated effort by a group of people to address some economic issue, such as the provision of a public good or the prevention of an externality.

Informational Asymmetries

- Informational asymmetries mean that some people have relatively difficult access to information that would allow them to make better choices, and as a result other people who do have access to that same information are able to gain an advantage

Public Goods

- Public goods and services are economic activities whose benefits can be easily enjoyed by many people but at the same time cannot be easily denied to people who don't pay for their provision.

The Principal-Agent Problem

A situation where a person who really cares about an economic outcome, called the principal, relies on somebody else, called the agent, to carry out activity on the principal's behalf. The problem arises whenever the principal cannot observe the agent's actions. How does the principal know if the agent is doing “the right thing”?

What do Legal and Institutional Reform projects accomplish?

Improvements in:

- The framework of laws, regulations, rules, procedures, and organizational structures, that various actors face in their decision-making;
- The resources that are devoted to upholding and enforcing the framework;
- The understanding and expectations that various people have of the framework.

Now, a word from our lawyer...

Lessons Learned:

1. History/Culture matters.

Because institutions have historical and cultural roots, change is slow.

Traditions and habits often make sense to people who hold them but not to outsiders.

EXAMPLE: Alternative dispute resolution.



Lessons Learned:

2. Stakeholders matter.

Do they *want* the reform?

Have we addressed incentives?

Can they comply?

Have we addressed capacity?

Are the stakeholders fighting amongst themselves?

Is there a common interest?

EXAMPLE: Collateral law in Egypt and in Albania as a way of broadening financial services.

Lessons Learned:

3. Writing a law does not accomplish reform.

Enforcement matters.

Accountability matters.

Public acceptance matters.

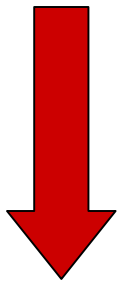
EXAMPLE: Antitrust law in Senegal as part of privatization strategy.

Lessons Learned:

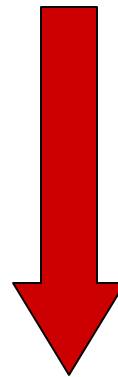
4. Interdisciplinary perspectives matter.

LIR needs

qualitative and quantitative analysis



Legal, political, and
institutional analysis



Empirical analysis.

EXAMPLE: Business disputes in Russia.

Now, let's work through an exercise that illustrates some (and I repeat some) of the issues that typically arise in Legal and Institutional Reform Projects. This exercise is based on an actual project.

Linkages between NIE and Anti-Corruption

- definitions of corruption,
- consider institutional causes of corruption,
- outline NIE's recommendations for anti-corruption strategies,
- .

Definitions

Abuse of public office for private gain

- **State capture** – inappropriate influence on the **formulation** of laws, regulations, and policies
- **Administrative corruption** - distorting the **implementation** of existing laws, rules and regulations.

NIE questions

- Who stands to benefit from administrative corruption? From state capture? Are there significant differences between the incentives of these two categories?
- Can reform of corporate governance – decision-making rules for firms – help address problem of corruption?

Institutional imbalances

- Perverse incentives in the civil service
- Monopolistic authorities
- Laws & regulations that allow officials large amounts of discretion as to implementation
- Subordinate judiciary instead of independent judiciary
- Legal/political constraints on civil society organizations

Corruption = monopoly + discretion
- accountability

- What is monopoly of authority?
- What is discretion?
- What is accountability?

Basic Recommendations for Anti-corruption

- Meritocracy
- Conflict of interest
- Notice and comment periods
- Watchdog organizations
- Choice of service providers
- Decentralization
- Regulatory efficiency
- “checks and balances”